

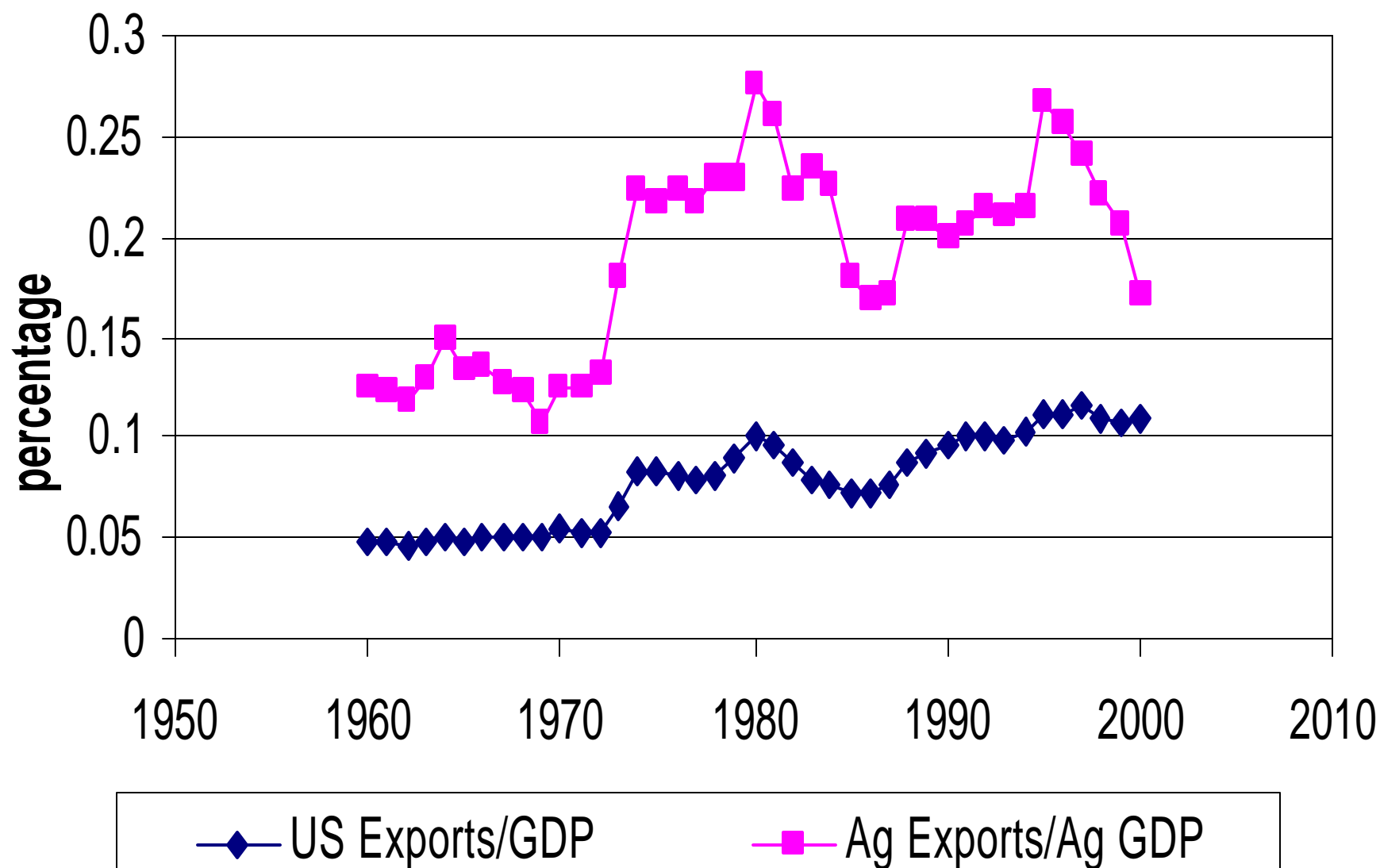


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Policy Choices in an Open Economy

- the U.S. economy has become more open and world financial markets have become more closely integrated
- what are the effects of macroeconomic and trade policies on incomes and asset values in U.S. agriculture?
- several direct and indirect effects of policies to consider

Total Exports/GDP and Ag Exports/Ag GDP



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Macro Policy Fundamentals

- a flexible exchange rate system
- the dollar is a commodity, the exchange rate is its relative price
- exchange rates are determined by economic conditions in goods markets and capital markets
- U.S. productivity growth, a “good news”
 - “bad news” story

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Monetary Policy Fundamentals

- the role of monetary policy - price stability
- interest rate parity:
 - (1) $De / e = DE / E + p_F - p_D$
 - (2) $r_D = (r_F - De / e)$
- changes in the nominal exchange rate (e)
 - two factors to consider
- changes in the real exchange rate (E)

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Fiscal Policy Fundamentals

- the role of fiscal policy - from deficits to projected surpluses
- fiscal stimulus: aggregate demand rises, short-run economic growth
- inflation and the nominal exchange rate again:
- (1) $De / e = DE / E + p_F - p_D$

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Agriculture in an Open Economy

- in the short-run macro policy may alter: farm prices, net incomes, asset values, and capital investments
- “channels” of monetary policy: interest rates, exchange rates, and credit availability

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Current Monetary Policy

- **easing of monetary policy by the Fed:
lower interest rates, increased credit
availability, lower exchange rate**
- **potential for slight improvements in the
domestic and export demand for crops**

Table 2. Short-Run Effects of Macroeconomic Policy Actions on Agriculture.

Effects of Policy On Farm	Expansionary Policy		Contractionary Policy	
	Monetary Policy	Fiscal Policy	Monetary Policy	Fiscal Policy
Crop Prices:				
Domestic Demand	Higher	Higher	Lower	Lower
Export Demand	Higher	Lower	Lower	Higher
Net Impact	Higher	Lower a/	Lower	Higher a/
Livestock Prices	Lower	Higher a/	Higher	Lower a/
Input Prices	Higher	Higher	Lower	Lower
Interest Rates	Lower	Higher	Higher	Lower
Net Income	Higher	Lower b/	Lower	Higher b/
Real Estate Prices	Higher	Lower b/	Lower	Higher b/
Capital Investment	Higher	Lower	Lower	Higher

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Current Fiscal Policy

- impact of the proposed Bush tax cut on agriculture is largely indirect
- size and timing of the tax cut will be important factors
- the short-run impact on interest rates and the exchange rate are not likely to be significant

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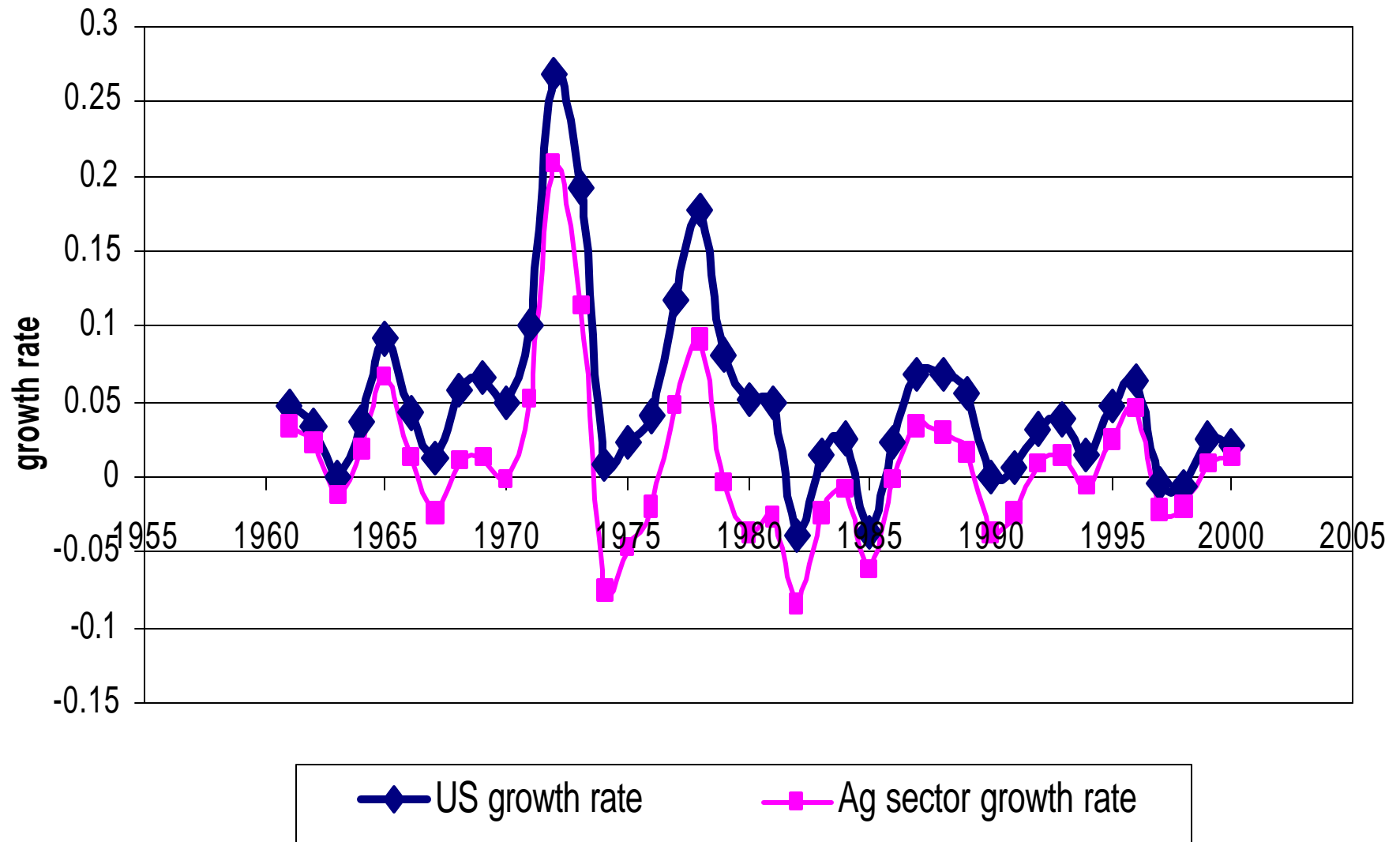
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Long-run Concerns

- incomes and asset values depend on the competitiveness of agriculture
- competitiveness depends on productivity growth
- domestic terms of trade for agriculture have worsened over time
- result: real GDP growth in agriculture has lagged behind

Figure 1. Real Growth Rates of US and Ag Sector GDP

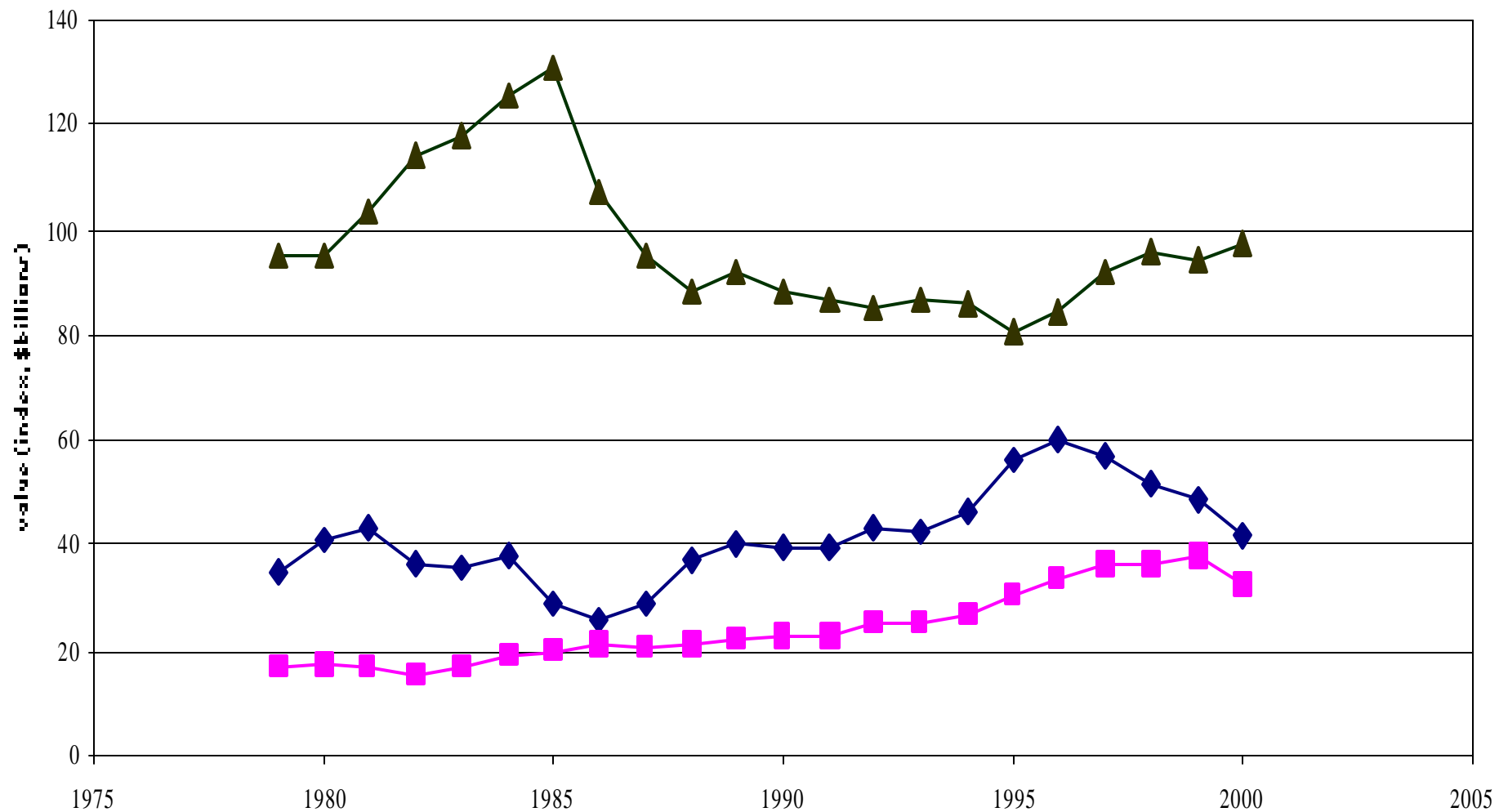


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Agricultural Trade

- the exchange rate acts like a tax on the demand for U.S. exports
- aggregate agricultural exports and imports are not highly sensitive to changes in the exchange rate
- individual farm commodity exports are more sensitive than aggregate exports

Figure 2. Exch. Rate, Ag. Exports and Imports



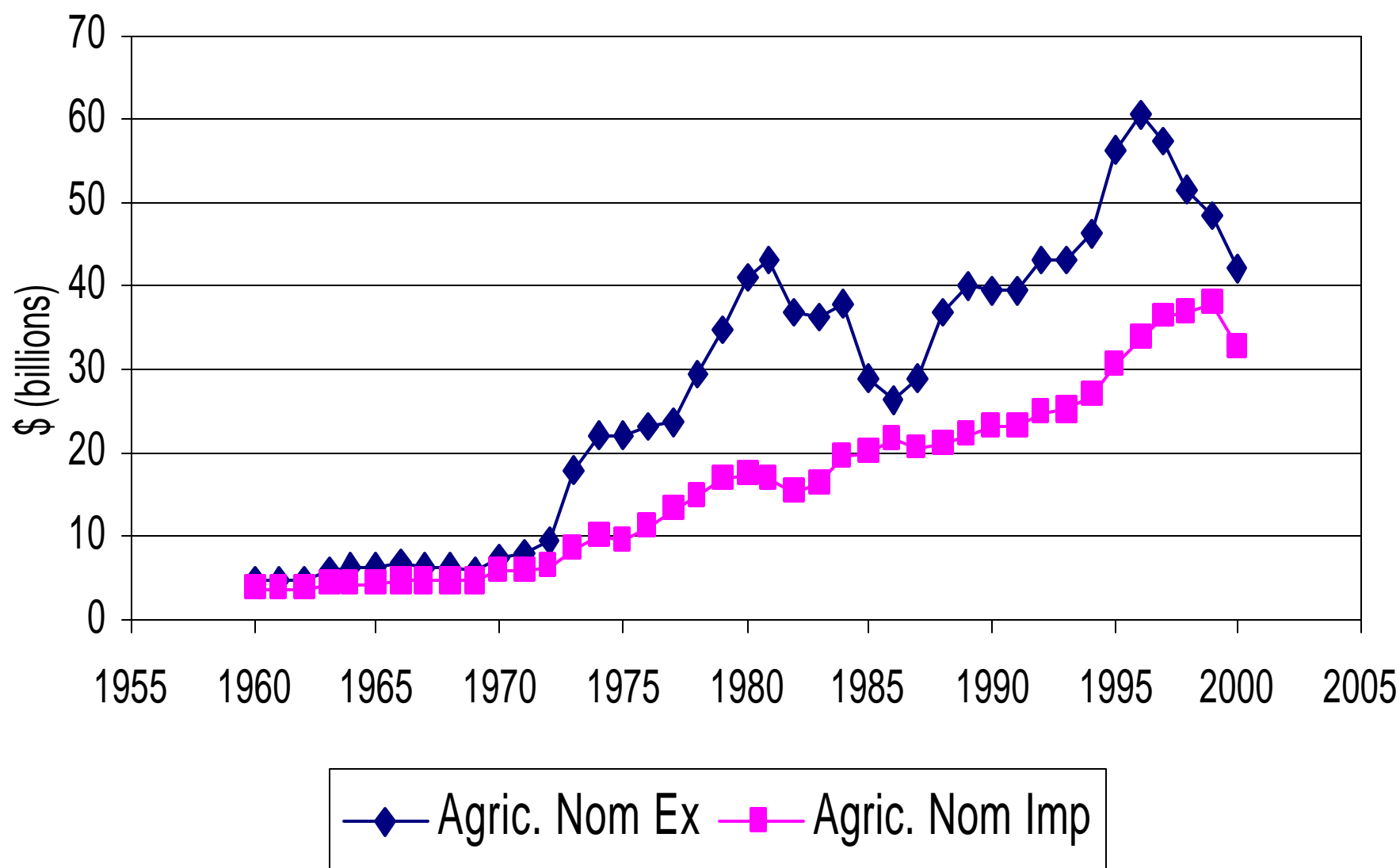
—▲— ER index(1973=100) —◆— Nominal Ag Exports —■— Nominal Ag Imports

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Agricultural Trade

- the rise in U.S. agricultural imports is due to lower world commodity prices
- the decline in value of U.S. agricultural exports is due to a drop in world demand
- exchange rate volatility did not play a major role in declining farm net exports

Figure 3. Nominal Ag. Exports and Imports



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Implications for Farmers and Lenders

- **current macro policy initiatives should be good medicine for agriculture**
- **the short-term picture for agriculture is slightly positive, the long-term picture is less positive**
- **international competitiveness depends on productivity growth in the sector**

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Implications

- **#1: need to focus on the strategic risks**
- **strategic risks are multidimensional and cannot be totally managed through conventional means**
- **emphasize flexibility, adaptability and diversification**

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Implications

- **lenders need to monitor credit risk at the portfolio level**
- **risk profiles: transaction risk, intrinsic risk and concentration risk**
- **intrinsic risk: sensitivities of commodity groups to macro and trade policy changes**

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Implications

- **#2: need to improve response time**
- **the Internet Age has changed the speed of response - e.g., inventories**
- **the response to changes in monetary policy occurs more rapidly**
- **the economic and financial effects of policy are transmitted faster**

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Implications

- **#3: the need to anticipate indirect effects**
- **indirect effects of macro and trade policies are larger than the direct effects**
- **indirect effects are transmitted via goods and capital markets**
- **these markets vary in sensitivity to changes in U.S. macro and trade policies**